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This Financial System Stability Assessment on Saudi Arabia was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on November 24, 2004. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Saudi Arabia or the Executive Board of the IMF.

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SAUDI ARABIA

Financial System Stability Assessment

Prepared by the Monetary and Financial Systems and Middle East and Central Asia Departments

Approved by Stefan Ingves and Mohsin Khan

November 24, 2004

This Financial System Stability Assessment (FSSA) is based on the work of a joint IMF–World Bank mission that visited Riyadh in January 2004 as part of the Financial Sector Assessment Program (FSAP). The mission met with the Minster of Finance; the Governor, senior management, and senior staff of the Saudi Arabian Monetary Agency; senior officers of the Saudi Arabian Riyal Interbank Express, the Capital Market Authority, the Real Estate Development Fund, and the Saudi Industrial Development Fund; and representatives of the banking, accounting, capital markets, and insurance industries. The FSAP findings were discussed further with the authorities during the Article IV consultation mission held in Washington in October 2004.

The FSAP team was led by David Marston (MFD) and comprised Wafik Grais (Deputy Chief, World Bank); Ashok Bhatia, Michael Gorbanyov, and Amadou Sy (all MFD); Tadashi Endo, Deane Jordan, and Valerie McNevin (all World Bank); Craig Heppleston (Reserve Bank of New Zealand); Francesco Drudi and Elias Kazarian (European Central Bank); Zarir Mohammad Rawi (Bank Negara Malaysia); and Stefan Spamer (Deutsche Bundesbank).

Despite an operating environment characterized by dependence on the hydrocarbons sector and periodic swings in investor confidence, the banking sector was found to be sound, with substantial capital, reserve, and liquidity buffers providing resilience to a range of simulated shocks. Conservative portfolios are underpinned by an evolving credit information system and an effective regulatory and supervisory structure. The payment system is modern and efficient, although further development of systemic liquidity arrangements could enhance overall resilience.

With the aim of diversifying the intermediation framework, deepening financial markets, and increasing access to financial services, far-reaching reforms are underway in capital markets, insurance, leasing, and market entry for foreign banks. While each activity has its own challenges, resolving the overarching and pervasive structural issue of residential collateral and its execution will be an important catalyst to market development.

The authorities broadly agreed with the mission's assessments but were confident that the issues raised on deepening systemic liquidity arrangements were not a constraint to resilience at this stage of development of the financial system. Moreover, the authorities felt that despite a formal supervisory structure that raised issues of independence, in practice the supervisory system worked well and supervisory independence was not an issue.

FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and crossborder contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

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Glossary

AGI	Autonomous government institution
AML	Anti-money laundering
ATM	Automated teller machine
BCL	Banking Control Law
CAR	Capital adequacy ratio
CFT	Combating the financing of terrorism
CIL	Cooperative Insurance Law
CML	Capital Market Law
CPSS	Committee on Payment and Settlement Systems
EFTPOS	Electronic funds transfer at point of sale
ERMS	Economic Returns Management System
FATF	Financial Action Task Force
FIU	Financial Intelligence Unit
FSAP	Financial Sector Assessment Program
FSSA	Financial Sector Stability Assessment
GCC	Gulf Cooperation Council
GDB	Government development bond
GOSI	General Organization for Social Insurance
IAIS	International Association of Insurance Supervisors
IFSB	Islamic Financial Services Board
IOSCO	International Organization of Securities Commissions
MRRR	Market-Related Repurchase Rate
NPL	Nonperforming loan
ORR	Official Repurchase Rate
PCCFT	Permanent Committee on Combating the Financing of Terrorism
PCCML	Permanent Committee on Combating Money Laundering
PMLAC	Permanent Mutual Legal Assistance Committee
REDF	Real Estate Development Fund
TRGS	Real-Time Gross Settlement
SAMA	Saudi Arabian Monetary Agency
SARIE	Saudi Arabian Riyal Interbank Express
SFD	Saudi Fund for Development
SIDF	Saudi Industrial Development Fund
SME	Small and medium-scale enterprise
SPAN	Saudi Payments Network
SRl	Saudi Arabian Riyal

I. Summary and Overall Assessment

1. **The capacity of the Saudi Arabian banking sector to respond to macroeconomic shocks has been considerably strengthened over the past decade**. Historically, the operating environment has been one of output volatility emanating from pervasive dependence on the hydrocarbons sector and swings in investor confidence associated with regional uncertainties. This experience has helped shape fairly risk-averse portfolios and the bank-led financial system has functioned with substantial capital adequacy ratios (CARs), loan-loss allowances, and liquidity buffers. The sector is profitable, with returns on assets averaging over 2 percent, supported by a low-cost demand deposit base even as lending rates are determined internationally. Stability is underpinned by an effective regulatory and supervisory structure that proactively contains risk-taking through the articulation of lending limits, including to connected parties caps on individual and corporate indebtedness, and preapproval requirements on foreign lending. The sector is supported by a modern and efficient payment and settlement infrastructure though there could be improvements in governance.[1]

2. **The banking sector is resilient to a range of single and combined shocks, although the infrastructure to manage liquidity risks could be strengthened**. Stress tests, using parameters drawn from past experiences in Saudi Arabia, suggest that the aggregate system is robust to various credit, liquidity, and interest rate events. This resilience, in turn, reflects most banks' conservative banking portfolios and large capital cushions. Some modifications to the arrangements to manage liquidity risk would be desirable, however, as the current market practice of augmenting the liquidity in the government securities market through the use of derivative products may be inadequate. In this regard, the incentive for interbank repurchase trades could be improved through a review of the pricing of the repurchase facility offered by the Saudi Arabian Monetary Agency (SAMA). Complementing this, however, a strategy to increase the tradable stock of government securities should be developed, as much of the stock is bought and held by investors, including the autonomous government institutions (AGIs).[2] In this regard, the SAMA's introduction of a "Dutch" auction process for government bonds in March 2004 and plans to introduce a system of primary dealers are welcome developments.

3. **The SAMA has been actively monitoring some emerging portfolio trends**. Already, there is an increase in margin lending for equities—albeit at banks that are not systemically important. While asset quality has been supported by strong aggregate corporate performance, more work is needed to assess the extent and implications of potential asset concentration. With consumer loans as a key growth area, household indebtedness is

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[1] The FSAP team completed detailed assessments of the *Core Principles for Effective Banking Supervision*, the *Core Principles for Systemically Important Payment Systems*, and the *Code of Good Practices on Transparency in Monetary and Financial Policy*.

[2] There are three AGIs: the Pension Fund, the General Organization for Social Insurance (GOSI), and the Saudi Fund for Development (SFD).

increasing. At the same time, closer attention to the commodity price risks inherent in some Sharia-compliant products may be warranted.

4. **Comprehensive reforms are underway to deepen financial markets and increase access to financial services**. Despite the overall robustness of the banking sector and its supporting infrastructure, domestic intermediation remains relatively limited, with bank claims on the private sector amounting to only 29 percent of GDP (or 51 percent of nonoil GDP). Far-reaching reforms aimed at developing a more diversified intermediation framework to meet the financing needs of the population are either being implemented or being considered, and should be supported by broader institutional efforts (Box 1).

5. **Notwithstanding the overhaul underway in capital market regulation, additional reforms could accelerate market deepening and the system's capacity for risk diversification**. The equity market is buoyant, with significant turnover and the largest market capitalization among Arab stock exchanges**,** however, there is limited provision of investment information. Corporate bond markets are fledgling and the statutory caps on issuance could be removed with an amendment to the Companies Law of 1965. The proposed introduction of a primary dealership system for Saudi government securities presents an opportunity to strengthen the functioning of the debt market to provide greater depth to systemic liquidity arrangements, broaden the base for deficit financing arrangements and, importantly, provide more robust yield curves that could catalyze longer-term markets.

6. **Resolving the pervasive structural issue of collateral registration and execution would serve as a major catalyst to market development**. Movable property registration and arrangements for the execution of collateral in lease transactions are well articulated.[3] Issues of enforcement and repossession of residential collateral in cases of default are legally more ambiguous. Finding a workable and effective framework to resolve these issues could foster a major expansion of market-based housing finance systems, complementing the resources provided by the government through the Real Estate Development Fund (REDF).

7. **Finally, the substantial reform program underway can only benefit from judicious articulation of clear "rules of the game."** Significant steps continue to be taken. The new Capital Markets Law (CML) and Cooperative Insurance Law (CIL) are major steps toward achieving compliance with International Organization of Securities Commissions (IOSCO) and International Association of Insurance Supervisors (IAIS) principles. The proposed establishment of a Commercial Business Court will supplement the framework for dispute resolution that has been working through the Committee for the Resolution of Banking Disputes and the Commercial Paper Disputes Committee. The CML envisages also the creation of the Committee for the Resolution of Securities Disputes. The importance of progress in these areas cannot be overstated.

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[3] The framework governing the leasing industry will be further strengthened with the enactment of the Financial Leasing Law currently under preparation.

Box 1. Priority Recommendations

Bank Supervision

- Consider amending the Banking Control Law (BCL) of 1966 or the Ministerial Decision on Rules Enforcing Provisions of the BCL to take into account financial system developments of the last four decades, including consolidated supervision and other modern prudential practices. *Inter alia*, the amendment should clarify the SAMA's authority and accountability arrangements, and the definition of confidentiality with regard to exchanges of information with domestic and foreign supervisors under Article 19 of the BCL.

Market Infrastructure and Safety Nets

- Reconsider the price at which the SAMA conducts its repurchase and reverse repurchase operations in order to lay the basis for secondary market transactions in Saudi government securities and facilitate the evolution of a more robust Saudi Arabian riyal (SRl) yield curve against which other markets can benchmark.

- Establish a formalized board of governance with ultimate responsibility for defining and implementing payment system policy for the Saudi Arabian Riyal Interbank Express (SARIE) payment and settlement system. In order to facilitate the work of such a board, the SAMA could consider setting up a dedicated payment and settlement system oversight team responsible for defining policy, issuing regulations, and monitoring all payment and settlement systems operating in the country, including the SARIE, the Saudi Payments Network (SPAN), the Clearing House, the stock exchange's securities settlement system, and the SAMA's settlement system.

Capital Markets

- Build the credibility of the Capital Market Authority in order to ensure good market practice and integrity through clear and transparent coordination arrangements between it, the SAMA, and the Ministry of Commerce and Industry.

- Amend the Companies Law in line with new developments in capital markets and insurance, with a particular focus on removing caps on corporate bond issuance.

Financial Services

- Overhaul the framework for housing finance, including mechanisms to facilitate the execution of collateral and, more broadly, to ensure that there exist arrangements to recognize creditors' liens on owner-occupied residential property and permit an effective, transparent, and predictable resolution process for enforcement.
.
- Similar features of collateral enforcement are also necessary to promote the expansion and reduce the cost of market-based financing of small and medium-scale enterprises (SMEs) and of leasing.

II. Macroeconomic Context and Vulnerabilities

8. **The Saudi Arabian economy remains heavily dependent upon the hydrocarbons sector, which is both the overarching wealth generator and a key source of volatility** (Table 1). Real oil sector GDP fluctuates with world oil demand (reflected in Organization of

Petroleum Exporting Countries quotas); it contracted by 7½ percent in 2002 as quotas were cut, expanded by about 15 percent in 2003 as quotas were increased, and is expected to grow by 5 percent in 2004. Nominal oil sector GDP tends to be still more volatile, fluctuating with both output volumes and swings in world oil prices. With oil proceeds accruing to the public sector, government expenditure serves as the key link between the oil and nonoil economies. Real nonoil GDP has grown at annual rates of 3–4 percent in recent years, insufficient to dent an unemployment rate of about 10 percent.[4] The upshot for the financial system is an operating environment where real activity experiences swings, and the dependence on the oil sector may limit the ability to domestically diversify risks.

9. **Developments in the fiscal position and external accounts largely mirror outturns in the oil sector, which generates 80–90 percent of government revenue and merchandise export proceeds**. The central government balance recorded a deficit equivalent to about 6 percent of GDP in 2002 as oil revenues fell, became a 1 percent surplus in 2003 as oil revenues recovered and expenditures were constrained, and is projected to record a surplus of almost 8 percent in 2004. With oil export values expected to expand by 32 percent in 2004, the current account surplus is projected to expand to about 20 percent of GDP, from about 14 percent in 2003.

10. **Favorable external vulnerability indicators underpin the durability of the pegged exchange rate regime**. Gross external debt, projected at about $18 billion at end-2004, is a fraction of the official foreign assets of the SAMA and the AGIs, which stood at $119 billion at end-September 2004.[5] Central government gross domestic debt, projected at 60 percent of GDP at end-2004, is high but almost one-third of the stock is held by the AGIs. Including the gross foreign assets of the AGIs, reserve coverage of short-term external debt by residual maturity exceeds 800 percent. Reflecting these and other factors, in mid-2003 Saudi Arabia obtained Standard & Poor's long-term foreign currency sovereign rating of "A," one notch below Kuwait and Qatar, and one notch above Bahrain. The SRl–dollar deposit rate differential averaged 24 basis points in the first three quarters of 2004.

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[4] Saudi Arabia has a population of 22.7 million (of which 27 percent are expatriates) and a GDP per capita of about $10,300. The rate of growth of the national Saudi population was 2.9 percent in 2003 and 56 percent of Saudis are below 20 years of age.

[5] Central government external debt is limited to *de minimis* volumes of government securities that may have been acquired by foreign investors through the secondary market.

Table 1. Saudi Arabia: Selected Economic Indicators, 1999–2004

	1999	2000	2001	2002	2003	Proj. 2004
National income and prices						
Nominal GDP (SRl bn.)	603.6	706.7	686.3	707.1	804.2	964.0
Oil sector (percent share)	33.5	41.5	37.6	37.7	42.4	50.4
Nonoil sector (percent share)	66.5	58.5	62.4	62.3	57.6	49.6
Nominal GDP (percent change)	6.2	17.1	-2.9	3.0	13.7	19.9
Oil sector	30.2	45.3	-11.6	3.1	28.1	42.7
Nonoil sector	-2.5	3.3	3.9	3.0	5.1	3.4
Real GDP (percent change)	-0.7	4.9	0.5	0.1	7.2	5.0
Oil sector	-7.6	6.9	-3.9	-7.5	14.9	5.0
Nonoil sector	3.2	4.0	3.5	3.7	3.8	5.0
Crude oil production (mn. barrels per day) 1/	7.56	8.09	7.89	7.60	8.40	8.90
Oil spot price (average, $ per barrel) 2/	17.45	26.81	23.06	23.40	27.00	36.70
Consumer price index (average, percent change) 3/	-1.3	-0.6	-0.8	-0.6	0.5	1.2
Central government finances			(As a percentage of GDP)			
Revenue	24.4	36.5	33.2	30.1	34.5	38.1
Of which: oil sector	17.3	30.3	26.8	23.5	28.7	32.8
Expenditure	30.5	33.3	37.2	36.1	33.3	30.1
Balance	-6.0	3.2	-3.9	-5.9	1.2	7.9
Gross debt 4/	103.5	87.2	93.7	96.9	82.1	60.0
Of which: held by AGIs 5/	79.9	67.0	68.7	74.6	60.9	...
Monetary survey			(Annual percentage change)			
Net foreign assets	-14.4	18.0	2.8	-5.2	26.0	46.1
Net domestic credit	10.1	-1.7	10.9	11.3	15.5	7.3
Claims on government	74.8	-17.3	22.6	14.7	12.0	-41.2
Claims on nonfinancial public sector	-39.2	-13.3	-13.0	10.6	116.1	3.4
Claims on private sector	1.0	6.2	8.6	10.0	11.0	27.4
Broad money (M3)	6.8	4.5	5.0	15.2	8.2	15.2
External sector			(In billions of dollars)			
Merchandise exports, f.o.b.	50.6	77.4	67.9	72.4	95.2	124.2
Of which: oil sector	44.8	70.7	59.7	63.7	84.1	111.3
Merchandise imports, f.o.b.	-25.7	-27.7	-28.6	-29.6	-33.9	-37.9
Trade balance	24.9	49.7	39.3	42.8	61.3	86.3
Current account balance	0.4	14.3	9.4	11.9	29.7	51.6
Capital account balance	-7.9	-4.6	-8.6	-18.4	-12.1	-31.4
Of which: commercial banks	0.7	1.0	-0.8	-3.4	3.1	-2.3
Of which: oil sector	-0.8	-1.9	0.0	-0.6	-0.6	-1.0
Overall balance	-7.5	9.7	0.8	-6.5	17.6	20.2
Memorandum items:						
Official gross foreign assets ($ bn.) 6/	69.7	81.8	82.7	77.9	98.2	118.9
SAMA gross foreign assets	39.4	49.0	48.5	42.0	59.8	77.5
Of which: liquid international reserves 7/	17.2	19.8	17.8	20.8	22.9	22.7
AGI gross foreign assets 5/ 8/	30.4	32.8	34.1	35.8	38.5	41.5
Total external debt ($ bn.) 9/	30.4	29.7	26.6	22.2	21.4	18.2
Of which: short-term by residual maturity	15.4	15.4	16.4	15.9	20.2	14.7
SRl–$ interest rate spread (average, basis points) 10/	82.0	24.0	25.0	53.0	52.0	24.0
Exchange rate (SRl per $)	3.745	3.745	3.745	3.745	3.745	3.745

Sources: Saudi Arabian authorities; and Fund staff estimates and projections.

1/ Including condensates and natural gas liquids.
2/ Arabian Light Crude.
3/ All Cities Cost of Living Index.
4/ Of which external component is *de minimis* .
5/ Pension Fund, GOSI, and SFD.
6/ Figure for 2004 is for September.
7/ Figure for 2004 is for August.
8/ Includes only the portion of AGI assets managed by the SAMA as fiduciary agent.
9/ Nonfinancial public sector, commercial banks (including nonresidents' deposits), and nonfinancial private sector.
10/ Differential between average rates on three-month SRl and Eurodollar deposits. Figure for 2004 is through September.

III. Financial System Overview

11. **Financial system reforms are central to the authorities' medium-term strategy of economic diversification and accelerated growth** (Box 2). Saudi Arabia has a diverse financial system compared with other countries in the region. By international standards, however, its banking sector is modest in size, with M3 equivalent to 52 percent of GDP at end-2003. Asset intermediation is limited, with commercial bank claims on the domestic private sector amounting to 29 percent of GDP (51 percent of nonoil GDP).[6] Crossborder activity, in contrast, is substantial, with commercial bank gross and net foreign assets amounting to 10 percent and 5 percent of GDP, respectively.

12. **The system remains bank-centric** (Tables 2–3). Assets of the 11 commercial banks operating domestically account for about one-half of total system assets. In addition, all commercial banks hold universal banking licenses and manage mutual investment funds. Public ownership is fairly extensive, exceeding 20 percent in five banks and reaching 79 percent in one bank. Foreign bank participation is mainly through substantial equity positions as opposed to majority shareholdings. Six banks have foreign equity stakes of 20 percent or more. Assets of the joint Saudi-foreign banks accounted for 49 percent of total banking sector assets at end-2003, compared with 53 percent in 1998.

13. **The nonbank portion of the system is dominated, in terms of asset size, by quasi-fiscal institutions**. The largest of these are the three AGIs, which dominate the primary market for government securities and hold a range of domestic and foreign investments, some managed on their behalf by the SAMA. There are also five specialized credit institutions, all of which extend interest-free loans for public policy purposes (in areas such as housing, agriculture, or industry). Most of them report to Boards of Directors appointed by the Council of Ministers. Two of the AGIs (the GOSI and the Pension Fund) and one of the specialized credit institutions (the Public Investment Fund) have equity ownership in the banking sector, including in the latter case a controlling stake in the largest Saudi commercial bank. Underscoring the still-embryonic character of nonbank financing in Saudi Arabia, the leasing companies, insurance companies, and licensed money changers together account for less than 0.3 percent of total financial system assets.

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[6] This figure is in the order of 35 percent for the 17 large developing countries reporting a full breakdown of banks assets and liabilities in the International Financial Statistics.

Box 2. Ongoing Financial System Reforms

Financial system reforms gathered pace in 2002–03, with progress on many different fronts. Key measures, either implemented or under consideration, include:

- **Gulf Monetary Union**: Gulf Cooperation Council (GCC) countries have agreed to establish a monetary union by 2010. As a first step, all GCC countries formally pegged their currencies to the dollar effective January 1, 2003. Progress toward the union will require a high level of convergence among member countries in all economic policies, including banking legislation.
- **Foreign Bank Entry**: Under a GCC agreement to permit bank licensing among member countries, the Gulf International Bank was granted a branch license in 1999. Four more GCC banks (the National Bank of Kuwait, the National Bank of Bahrain, Emirates Bank International, and the Bank Muscat) were granted branch licenses in 2002–04. A liberalized licensing policy is being extended to non-GCC banks also, with licenses issued to Deutsche Bank, JP Morgan, and BNP-Paribas in 2004.
- **Bank Supervision**: The SAMA issued a circular prescribing minimum criteria for loan classification and specific provisioning in January 2004, with nonperforming loans (NPLs) clearly defined. In addition, a new Saudi Credit Bureau was established in March 2004, a draft circular on a proposed market risk amendment has been issued, and a circular on country risk and transfer risk is under consideration.
- **Islamic Finance**: The SAMA became a founding member of the Islamic Financial Services Board (IFSB) in late 2002. The IFSB will define Sharia-compliant principles for the rapidly growing Islamic finance industry, including supervisory standards.
- **Capital Markets**: The new Capital Markets Law (CML, promulgated in mid-2003, has led to the establishment of the Capital Market Authority, with a five-member governing board and a Committee for the Resolution of Securities Disputes, and a Saudi Arabian Stock Exchange with the legal status of a joint-stock company, with the latter consisting of Tadawul, the electronic share trading system hitherto run at the SAMA, and the Securities Deposit Center. The Capital Market Authority's board was appointed in July 2004.
- **Government Debt Market**: The SAMA instituted a "Dutch" auction process for its monthly issues of government bonds from March 2004, and a primary dealership network is planned.
- **Payment System**: The establishment of a Board of Governance with ultimate responsibility for defining and implementing all policies relating to the payment system is under consideration.
- **Insurance**: The new CIL creates a licensing and regulatory framework for the hitherto underdeveloped insurance sector, with responsibility for oversight formally entrusted to the SAMA. Implementing Regulations were issued in April 2004.
- **SME Loan Guarantee Scheme**: The government and the commercial banks are jointly funding, in equal shares, a loan guarantee scheme with a total capitalization of SRl 200 million to cover loans to eligible SMEs. The scheme, which will began operation in 2005, is expected to incorporate guarantee ceilings of SRl 1.5 million and 75 percent of the underlying loan. The state-owned SIDF will manage the scheme, which, depending on the advice of a new Board of Advisors, may or may not include interest rate caps.
- **Consolidation of Exchange Companies**: The Council of Ministers has approved the license for a new commercial bank to be formed from the merger and transfer of business of the eight largest money changing companies. The new bank will carry out Sharia compliant banking business.
- **Creditor Rights**: A Financial Leasing Law is being drafted, and a Mortgage Finance Law is in concept stage. While the former will address important issues needed to accelerate the development of the leasing industry, the latter will need to grapple with the difficult issues of immovable collateral.

Table 2. Saudi Arabia: Financial System Structure, 2003

		Assets		
	Number	SRl bn.	Percent of GDP	Percent share
Banking sector	11	543.1	67.5	42.4
Saudi commercial banks	10	540.0	67.1	42.2
Foreign commercial banks with Saudi branches	1	3.1	0.4	0.2
Investment funds	170	53.9	6.7	4.2
Specialized credit institutions	5	244.6	30.4	19.1
Leasing companies	2	0.4	0.1	0.0
Insurance companies 1/ 2/	98	2.7	0.3	0.2
Licensed money changers 1/	35	0.1	0.0	0.0
AGIs 3/	3	435.7	54.2	34.0
Total	324	1,280.5	159.2	100.0

Source: SAMA.

1/ Figures are for end-2002.
2/ Of which only the National Company for Cooperative Insurance is incorporated in Saudi Arabia.
3/ Includes only the portion of Pension Fund, GOSI, and SDF assets managed by the SAMA as fiduciary agent. Figures are for November.

Table 3. Saudi Arabia: Banking Sector Structure, 2003

	Equity stakes (percent share)		Deposits		Assets	
	Public sector	Foreign investors	(SRl mn.)	(Percent share)	(SRl mn.)	(Percent share)
Saudi commercial banks 1/	23.0	18.8	403.3	99.9	540.1	99.4
National Commercial Bank	79.3	0.0	90.4	22.4	117.4	21.6
SAMBA Banking Group	20.3	23.6	61.8	15.3	79.0	14.5
Riyad Bank	48.9	0.0	45.9	11.4	71.6	13.2
Al-Rajhi Banking and Investment Corp.	9.7	0.0	49.3	12.2	64.7	11.9
Banque Saudi Fransi	11.3	31.1	42.6	10.6	53.5	9.9
Arab National Bank	8.7	40.0	33.7	8.3	49.2	9.1
Saudi British Bank	8.6	40.0	36.1	8.9	46.1	8.5
Saudi Hollandi Bank	7.3	40.0	21.6	5.4	27.9	5.1
Saudi Investment Bank	35.9	7.5	14.4	3.6	21.7	4.0
Bank Aljazira	0.0	5.8	7.5	1.9	9.0	1.7
Gulf International Bank 2/	20.0	80.0	0.4	0.1	3.0	0.6
Total (or average, for equity stakes)	22.7	24.4	403.7	100.0	543.1	100.0

Source: SAMA.

1/ Audited consolidated reports, including branches abroad.
2/ Incorporated in Bahrain and operating in Saudi Arabia under a branch license.

IV. Banking Sector Stability

A. Portfolio Behavior

14. **Bank portfolios in Saudi Arabia are shaped by three factors**. First, assets are substantially funded by low-cost demand deposits, which account for up to 40 percent of total deposits, which with lending rates determined internationally largely explains consistently robust profitability. Second, the dependence of the economy on oil makes it difficult for banks to diversify risks domestically, particularly credit risk, necessitating high levels of capital and provisioning. Third, conservatism is further ensured by prudential arrangements that prescribe lending limits, including to connected parties, liquid asset ratios, require SAMA approval for foreign lending, and impose statutory caps on individuals'

indebtedness. In this environment of "managed risks", and with advanced asset-liability management by banks, stability has been assured but intermediation has remained modest (Figure 1).

15. **Asset quality has improved in spite of a high correlation of credit risk across all sectors of the economy, although some trends are worrying** (Table 4). The NPL ratio has decreased steadily since 1998, reflecting benefits to the economy and the banking sector of a recovery in oil prices. Provisions coverage of NPLs, at 119 percent, is high but appropriate given the operating context. Further work may be warranted in assessing the extent of loan concentration. Banks and supervisors are actively monitoring the rapidly increasing portfolios of consumer "instalment lending" and margin lending, which now account for some 30 percent and 3 percent of total loans, respectively.[7] The household sector's ratio of bank liabilities to disposable income has doubled in less than two years, and the General Share Price Index increased by 162 percent between end-2002 and end-September 2004.[8]

16. **Disclosure and loan classification arrangements that underpin capital measures could be enhanced**. In particular, the transparency of the nature of credit risk on Sharia-compliant products could be improved (Box 3).[9] New SAMA guidelines to apply a consistent methodology for classifying NPLs and applying appropriate provisions are welcome.

B. Stress Tests

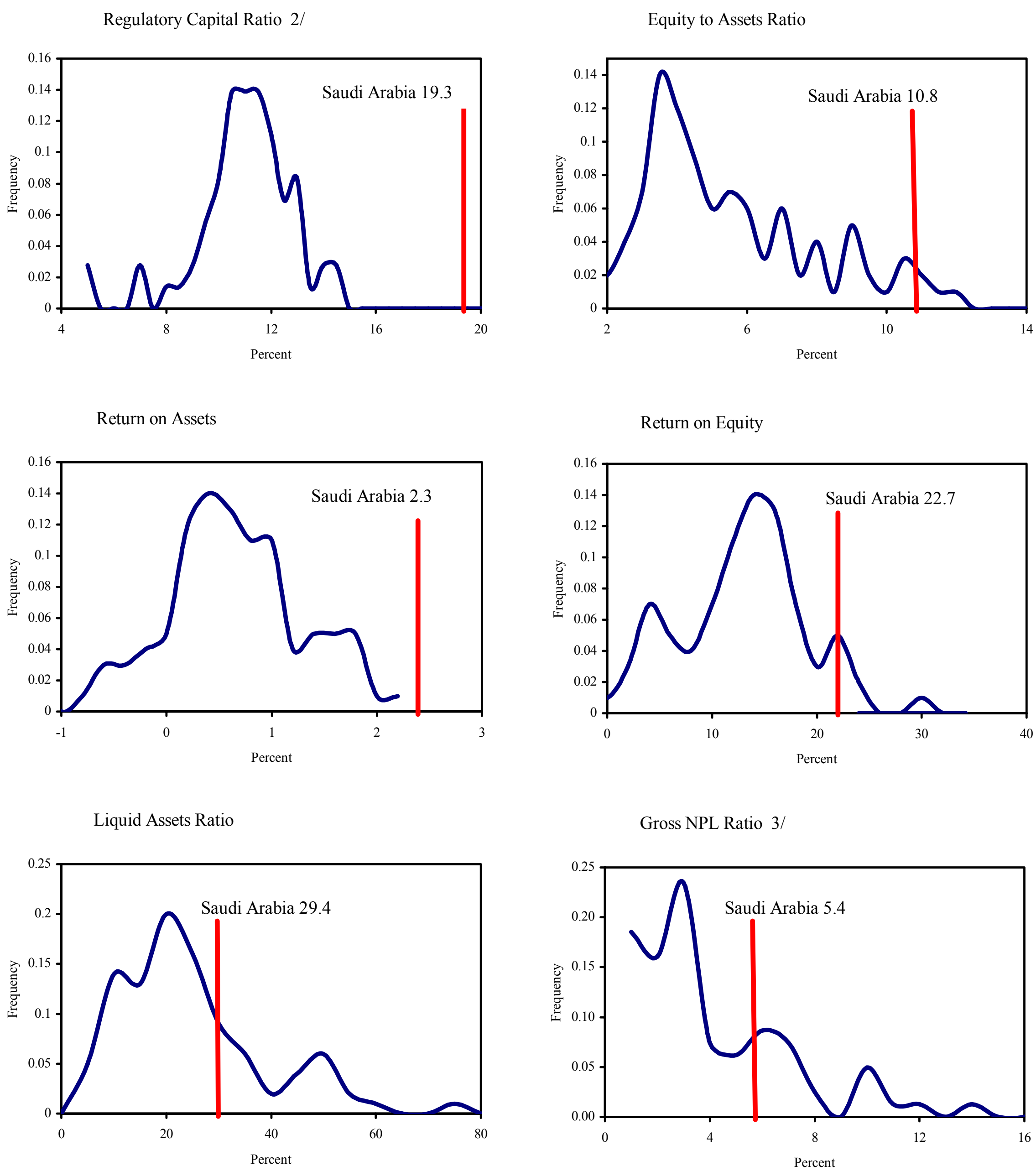
17. **Stress testing is rendered all the more important in Saudi Arabia by the fact that the same three banks dominate the government securities market, handle most payment orders through the SARIE, and are the net placers of funds in the interbank markets**. The systemic importance of these institutions in a relatively small banking sector cannot be overstated as vulnerabilities are amplified by this concentration.

[7] The SAMA monitors consumer loans through monthly regulatory returns supplemented by ad hoc surveys, with a particular focus on margin lending.

[8] Installment payments on consumer loans (interest and principal) may not exceed 30 percent of salary, by law. Banks are not allowed to lend after this limit on an noncollateralized basis. It is difficult to ascertain the extent to which consumer loans are used to finance share purchases. Notwithstanding market circuit breakers that halt trading if prices fall or increase by more than 10 percent in one day, banks and regulators need to be alert to the systemic implications of "overheating."

[9] For instance, one bank in its annual report for 2002 discloses a range of Islamic investments totalling SRl 41.8 million and reports a credit exposure of only SRl 1.6 million.

Figure 1. Saudi Arabia: Banking Sector in Global Context, 2003 1/



Sources: Bankscope; and SAMA.

1/ Frequency distributions for largest 100 banks reported in the Bankscope database.
2/ Based on 72 of the largest 100 banks.
3/ Based on 81 of the largest 100 banks.

Table 4. Saudi Arabia: Financial Soundness Indicators, 1999–2003
(In percent unless otherwise indicated)

	1999	2000	2001	2002	2003
Banking sector					
Capital adequacy					
Regulatory capital to risk-weighted assets	21.2	21.0	20.3	18.7	19.3
Tier I capital to risk-weighted assets	17.8	17.1	17.5	17.3	14.9
Asset quality					
Net loans to total assets	35.9	34.5	34.8	36.7	39.9
Gross NPLs to net loans	11.4	10.4	10.1	9.2	5.4
Total provisions to gross NPLs	88.0	99.0	107.0	110.4	136.0
Net NPLs to total capital 1/	5.0	0.2	0.0	0.0	0.0
Loans to property sector to total loans	2.6	3.0	2.2	1.9	2.0
Loans to domestic manufacturing sector to total loans	14.3	13.6	13.1	11.5	10.4
Loans to other banks and financial institutions to total loans	23.8	26.2	23.5	21.1	19.7
Profitability					
Return on assets	0.9	2.0	2.2	2.3	2.3
Return on equity	9.1	21.0	21.9	22.2	22.7
Noninterest expenses to total income 2/	44.8	41.4	39.4	39.4	36.2
Spread between reference loan and deposit rates (percentage points)	4.5	3.9	4.1	4.3	3.4
Liquidity					
Liquid assets to total assets	32.1	31.4	30.6	30.3	29.4
Liquid assets to short-term liabilities 3/	50.6	51.1	49.8	45.3	41.8
Customer deposits to loans	140.7	144.1	138.8	146.5	137.9
Demand deposits to total customer deposits	45.2	46.6	49.7	48.5	49.9
Sensitivity to market risk					
Foreign currency-denominated deposits to total deposits	20.1	18.6	17.9	18.2	18.0
Foreign currency-denominated loans to total loans	28.9	25.4	24.3	19.5	18.4
Net open foreign currency position to capital	90.0	81.3	80.1	23.8	13.8
Net open derivatives position to capital	...	...	1.6	0.9	0.3
Nonfinancial corporate sector 4/					
Capital structure					
Debt to equity	87.4	42.0	38.5	44.0	...
Debt to GDP	28.0	10.1	15.5	17.2	...
Short-term debt to total debt	46.6	50.1	52.0	49.5	...
Profitability					
Pretax return on assets	1.6	5.8	3.4	4.1	...
Pretax return on equity	4.4	12.2	7.1	8.5	...
Household sector					
Net disposable income to GDP	78.1	79.5	78.9	77.6	...
Net savings to GDP	10.8	16.9	13.5	15.1	...
Net savings to net disposable income	13.8	21.3	17.2	19.4	...
Liabilities to banks to gross disposable income	3.1	4.8	7.5	9.6	...

Source: Saudi Arabian authorities.

1/ Provisions exceed gross NPLs in 2001–03.
2/ Total income includes net interest income and gross noninterest income.
3/ Short-term liabilities include demand deposits maturing in 90 days or less.
4/ Publicly traded companies only.

Box 3. Sharia-Compliant Finance

Reflecting Koranic prohibition of *riba* (usury), some 40 percent of deposits are non-interest-bearing, a key structural factor supporting the profitability of the banking sector.

The share of Sharia-compliant banking services and products has grown rapidly in recent years. All Saudi Arabian commercial banks are involved in Sharia-compliant finance, albeit with different strategies. Al-Rajhi Banking and Investment Corporation, which offers only Sharia-compliant products, is the world's largest in that sector. In other banks, non-interest-bearing deposits are segregated from other deposits and are intermediated through Sharia-compliant investments. In addition, a number of banks offer Sharia-compliant products through dedicated branches or divisions. All banks base their portfolio decisions on the advice of internal Sharia advisory boards.

Deferred sales and *murabaha* transactions are the main Sharia-compliant investment vehicles. Deferred sales accounted for 46 percent of total Sharia-compliant banking sector assets at end-2003, while *murabaha* transactions accounted for 31 percent (Table 5.) In addition to Sharia-compliant products provided by the banks, there were 59 Sharia-compliant mutual funds at end-2003, with SRl 39 billion of assets under management, accounting for 75 percent of total mutual fund assets.

Table 5. Saudi Arabia: Sharia-Compliant Assets of Banking Sector, 1999–2003
(As a percentage of total banking sector assets)

	1999	2000	2001	2002	2003
On balance sheet	11.2	13.0	15.0	17.0	21.0
Off balance sheet	1.7	2.1	2.3	2.0	2.3

Source: SAMA.

18. **Stress test results suggest that the Saudi banking sector is robust to a range of single or combined shocks** (Table 6). Various credit, liquidity, and interest rate events were simulated, using parameters drawn from past experiences in Saudi Arabia. The unique portfolio advantage of having almost 40 percent share of low cost liabilities is a substantial shock-absorber. Low loan-deposit ratios and high levels of capital and provisioning also serve the sector well, even in the more severe simulations. The banking sector's exposure to the stock market remains limited and concentrated in banks that are not

Table 6. Saudi Arabia: Banking Sector Stress Tests 1/

Description and key assumptions	Input and output parameters			
I. **Credit risk shock**				
Stylized description:				
• A period of low oil prices causes the government to reduce domestic expenditures, adversely affecting the credit quality of banks' loan portfolios				
Key assumptions:	Gross NPLs (percentage increase)			
• The ratio of total provisions to gross NPLs remains unchanged at its end-2002 value of 110 percent	Pre-shock	Shocks		
	0	70	100	200
Key outputs:				
• System average gross NPLs to total loans (percent)	7.2	12.2	14.4	21.5
• Number of banks with CARs < 8 percent	0	0	1	1
– Aggregate assets (percent of system assets)	...	...	21.5	21.5
– Aggregate capital shortfall (SRl bn.)	...	...	2.0	9.5
• Number of banks with CARs < 13 percent	0	2	2	7
– Aggregate assets (percent of system assets)	...	26.9	26.9	70.6
– Aggregate capital shortfall (SRl bn.)	...	2.0	4.3	13.9
II. **Liquidity shock**				
Stylized description:				
• Some domestic or regional event, or combination thereof, triggers deposit runs				
Key assumptions:				
• 100 percent of interbank deposits are unwound				
• 21 percent of gross foreign assets are liquidated				
• 80 percent of excess reserves with the SAMA are withdrawn	Customer deposits (percentage decrease)			
• Transient 500 b.p. increase in SRl interest rates reduces the market value of Saudi GDBs by 25 percent	Pre-shock	Shocks		
	0	10	15	20
Key outputs:				
• Aggregate repurchase requirement with the SAMA (SRl bn.)	...	29.3	45.8	63.0
	...			
III. **Interest income shock**				
Stylized description:				
• A reduction in world and domestic interest rates, sustained for one year, erodes banks' profitability and capital	Interest rates (basis point decrease)			
	Pre-shock	Shocks		
	0	200	300	500
Key outputs:				
• Number of banks with CARs < 8 percent	0	0	0	0
• Number of banks with CARs < 13 percent	0	0	0	0
IV. **Combined shock**				
Stylized description:				
• A period of low oil prices and declining credit quality is followed by an event that triggers deposits runs	Pre-shock	Shocks		
Key assumptions:	Gross NPLs (percentage increase)			
• The ratio of total provisions to gross NPLs remains unchanged at its end-2002 value of 110 percent	0	70	100	200
		and		
• 100 percent of interbank deposits are unwound	Customer deposits (percentage decrease)			
• No liquidation of gross foreign assets	0	10	15	20
• 80 percent of excess reserves with the SAMA are withdrawn		*and*		
• Transient increases in SRl interest rates reduce the market value of Saudi GDBs by varying amounts	Interest rates (basis point increase)			
	0	300	500	1,000
Key outputs:				
• System average gross NPLs to total loans (percent)	7.2	12.2	14.4	21.5
• Number of banks with CARs < 8 percent	0	0	1	1

systemically important.[10] Overall, only one bank routinely underperforms and requires careful monitoring, given its systemic importance.

V. Market Infrastructure

A. Systemic Liquidity Arrangements and Safety Nets

19. **Domestic money markets are shallow, and most banks manage their liquidity primarily through derivatives trades**. Turnover in the interbank markets stood at about 1.5 percent of deposit liabilities at end 2003. The use of Treasury bills and certificates of deposit is negligible. In the conduct of its monetary operations, the SAMA uses repurchase and reverse repurchase agreements to inject or drain liquidity. The main money market benchmark rates are the Market-Related Repurchase Rate (MRRR) and the Reverse Repurchase Rate, used for transactions. The MRRR is set as an average of banks' deposit rates from overnight to one week.

20. **The SAMA repurchase facility substantially reduces systemic liquidity risks**. Banks may at any time tender up to 75 percent of the market value of eligible government securities portfolio as collateral for repurchase agreements with the SAMA. The facility is actively used. In 2003 for instance, repurchase and reverse repurchase agreements between banks and the SAMA averaged SRl 1.9 billion and SRl 2.7 billion per day, respectively. The repurchase facility effectively guarantees systemic liquidity. Moreover, in a context where the liquidity of derivative markets has fallen, the tradable stock of government securities is limited by the buy-and-hold strategies of the AGIs, and the interbank repurchase market is shallow, the SAMA's nonpenal pricing has made it a counterpart by default. Changing this incentive structure will be important in deepening systemic liquidity arrangements. However, the authorities are confident that the issue on deepening systemic liquidity arrangements was not a constraint to resilience at this stage of development of the financial system.

21. **The BCL details the regulatory and supervisory powers of the SAMA, including modalities for intervention in insolvent institutions**. SAMA, however, relies on proactive containment of excessive risk taking and high frequency interaction with banks to ensure ongoing solvency. Though the need for intervention has been rare, there have been two reported instances of public sector-funded bank recapitalization in Saudi Arabia. The first, in 1961, followed a SAMA-administered merger of two banks compromised by irregularities, with the Ministry of Finance providing a cash injection through the SAMA and assuming a 38 percent equity stake in the restructured entity. The second, in 1986, followed the SAMA's legal action against the management of a bank that had concealed large losses, with the SAMA requiring a doubling of its share capital, subscribed to in its entirety by the Public Investment Fund.

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[10] The banking sector's exposure to equities is quite limited, amounting to about 3 percent of total assets, and it is only at the smallest bank in Saudi Arabia that the exposure is significant.

B. Debt and Derivatives Markets

22. **Domestic debt markets are fledging and holdings of government debt securities are concentrated**. Among the three AGIs, two, the Pension Fund and the GOSI, run large annual cash surpluses, face substantial long-term SRl-denominated liabilities streams, and are the principal institutional buyers of government securities. Together, the Pension Fund and the GOSI own some three-quarters of the central government debt stock. Both institutions are buy-and-hold investors. The SAMA's Investment Department conducts monthly auctions and cites the volume of bond offtake as its primary objective.[11] The SAMA's repurchase facility and its classification of 100 percent of banks' holdings of government securities as regulatory liquid assets could be supporting bank appetite for government development bonds (GDBs). Both measures, however, preclude the need for secondary market trading in such securities, and the resulting lack of a meaningful long-term SRl yield curve impedes the establishment of a domestic corporate bond market.

23. **Derivatives are actively used by Saudi banks for trading purposes, i.e., purposes other than hedging, presumably in order to supplement the limited liquidity of the secondary market for GDBs** (Table 7). SRl interest rate swaps of 1–5 years' maturity on the commercial banks' books amount to 5–10 percent of their GDB holdings. Swaps are traded over the counter and often intermediated by inter-dealer brokers operating out of Bahrain. SRl interest rate swaps with maturities of up to one year are highly liquid, including for amounts as large as SRl 500 million. Liquidity falls off sharply for maturities in excess of two years.[12] The SRl–dollar peg entices some market participants to seek liquidity for maturities

Table 7. Saudi Arabia: Notional Volume of Derivatives Contracts 2002–03
(In millions of SRl unless otherwise indicated)

	2002	2003
By market:		
Over the counter	1,404	1,370
Exchange-traded	457	503
Total	1,861	1,873
By contract type:		
Foreign exchange	1,662	1,653
Interest rates	199	217
Other	0	3
Total	1,861	1,873
By maturity (percent share):		
0–3 months	76.1	77.6
3–6 months	8.6	7.7
6–12 months	6.7	6.7
> 12 months	8.6	8.0
Total	100.0	100.0

Source: SAMA.

[11] Instruments include Treasury bills, ranging from one week to one month in maturity; floating rate notes, with bullet maturities at five years and seven years; and GDBs, with bullet maturities at two, three, five, seven, and ten years. The AGIs are concentrated at the long end of the maturity spectrum and, pending the establishment of primary dealerships, the only other participants are the banks. In March 2004 the SAMA introduced a "Dutch" auction system for pricing GDBs, replacing the previous system of predetermined prices.

[12] According to a market source, two-year SRl interest rate swaps trade at a bid-offer spread of 15 basis points for SRl 100–200 million, and five-year swaps at 20–25 basis points for SRl 50–75 million. Currently, there are four market-makers for SRl interest rate swaps.

in excess of two years in the dollar interest rate swap market. Divergence between the dollar and SRl interest rates becomes a potential risk in these hedging programs. Derivatives and repurchase transactions use standard documentation, viz., Security Lending Agreements and Customer Treasury Agreements, with the latter compatible with the requirements of the International Securities Deposit Association.[13] Most contracts are of short maturity, and the market appears to be concentrated in the three largest banks.

C. Payment and Settlement Systems

24. **All interbank payment transfers are processed through the SARIE system, which is operated and regulated by the SAMA**. The SARIE is a fully integrated real-time gross settlement system and is both a large-value and a high-volume payment system. It handles both credit transfers and direct debits and permits all banks in Saudi Arabia to make intermediate payments over accounts held at the SAMA. It is also the framework for other payment and settlement systems operating in Saudi Arabia. It processes the banks' net positions in automated teller machine (ATM) and card payments, check clearing, and securities settlement systems for equities. The settlement of government securities is handled on a gross basis with all individual trades being settled throughout the day on a real-time gross settlement basis over the SARIE. The daily value of transactions processed through the SARIE averaged SRl 21 billion in 2003.

25. **The use of non-cash payment instruments in the form of payment cards (ATM and point-of-sale) has grown in recent years, and the use of checks has declined**. The SAMA set up the SPAN in 1990 and enhanced it in 1993 to support point-of-sale transactions. The SPAN is a neutral national transaction system that works on the basis of full interoperability between the ATMs of all banks. In response to the rapid and sustained growth of the SPAN, the SAMA has initiated a project to enhance the SPAN infrastructure. The use of checks as a noncash payment instrument is decreasing in importance.[14] In addition, the SAMA is studying the potential benefits of introducing electronic checks and check imaging into the payment system.

VI. Regulatory Oversight and Transparency

A. Bank Regulation and Supervision

26. **Arrangements for bank supervision and regulation are effective and, with few exceptions, adhere to the Basel Committee's *Core Principles for Effective Banking***

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[13] For netting purposes, banks execute a separate agreement supplementary to a Customer Treasury Agreement.

[14] The volume of checks decreased by 2 percent in 1996–2000, compared with an annual rate of increase of about 30 percent in 1992–96. The total value of checks has decreased remarkably, from SRl 3,296 billion in 1996 to SRl 463 billion in 2000.

Supervision. The essential preconditions are met through a clear empowering framework reflected in the SAMA Charter of 1957 and the BCL of 1966, supplemented by circulars and administrative guidelines issued pursuant to the BCL. Despite a history of SAMA recommendations not being challenged, legal clarity on SAMA's authority and the associated accountability arrangements would be desirable. Legal protection for supervisors, is not addressed in either the framework laws or the supporting regulations.

27. **The essential elements for effective ongoing prudential regulation and supervision are in place, albeit with a few deficiencies**.[15] While currently absent, a market risk amendment has been issued to banks with a view to implementation in the first quarter of 2005. Although the current trading portfolio is relatively small, the implementation of the market risk amendment is necessary, as Saudi Arabia is a developed financial center and new foreign banks plan to enter the domestic market. In managing credit risk, the legal framework specifies requirements for credit exposures to connected parties, but is silent on the prohibition of lending to connected parties on preferential terms and does not specify that approval for connected lending be carried out at the higher management, i.e., committee or board, level.[16] As regards the management of country risk and transfer risk, the regulations require that all loans to nonresidents be approved by the SAMA and in this context, country and transfer risks are assessed. Know-your-customer regulations have been substantially strengthened in the context of a new Anti-Money Laundering (AML) Law passed in 2003 as well as supplemental guidelines.[17]

28. **In its design of regulation and supervision and in its implementation of the *Core Principles*, the SAMA makes no differentiation between conventional and Sharia-compliant banking arrangements**. There is recognition, however, that some Sharia-compliant instruments carry unique risks, e.g., commodity price risk in deferred-sale transactions and property price risk in Islamic housing finance. In this evolving area of supervision, the SAMA is an active member of the IFSB's working groups.

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[15] The SAMA issued a circular defining minimum criteria for loan classification and specific provisioning in January 2004. The circular identifies NPLs as substandard loans (overdue by 90–179 days), doubtful loans (180–364 days), and loss loans (365 days or more), provisioned at 25 percent, 50 percent and 100 percent, respectively. Exceptions to the new guidelines may be granted on a case-by-case basis and are expected to be limited to cases involving registered collateral, guarantees, or other support.

[16] Given the structure of the economy, credit concentration could be of importance. However, the mission did not have the information to make an assessment.

[17] A Financial Action Task Force (FATF) mutual evaluation exercise has been also been completed. (See Section D).

29. **The ongoing supervisory function is performed through a combination of offsite, full, and limited-scope onsite monitoring**. Limited-scope on-site monitoring is triggered by some preexisting concern. With regard to full-scope on-site supervision, the periodicity of examinations has evolved into a triennial cycle and the risk profile of banks' departments and functions are taken into account in prioritizing the focus of examinations. In the context of consolidated supervision, more explicit powers would be needed to allow the SAMA to perform its supervisory function on bank holding companies or sister companies, if the banking structure in Saudi Arabia were to change and the financial system were to expand. Moreover, while the SAMA has the authority to supervise banks on a consolidated basis, there are no legal provisions—beside the very general and broad provision of Article 3 (d) of the SAMA Charter—for the establishment of contact and for information sharing of SAMA with cross-border supervisory counterparts. Notwithstanding the fact that the SAMA, in practice, has close working relationships with counterpart supervisors, consideration should be given to formalizing such arrangements.

B. Payment and Settlement Oversight

30. **Oversight of the SARIE fully observes best practice as established by the Committee on Payment and Settlement Systems (CPSS) *Core Principles for Systemically Important Payment Systems*, but a strengthened governance framework may now be needed**. Beyond its narrow function of facilitating real-time settlement of transactions, the SARIE has evolved into a critical technology platform that has substantially changed banking and corporate practice. Various policy challenges are emerging, not least of which is the prospective GCC monetary union. Consideration as to the status of the SARIE in this context, and in continuing its role of reforming business practice within Saudi Arabia, may now warrant the establishment of a formalized board of governance with ultimate responsibility for defining and implementing payment system policy. Facilitating the work of such a board, the SAMA could consider setting up a dedicated payment and settlement systems oversight team**.** Such a team would be responsible for defining policy, issuing regulations, and monitoring all payment and settlement systems operating in the country, including the SARIE, the SPAN, the Clearing House, Tadawul's securities settlement systems, and the SAMA's settlement system.

31. **More generally, with the changing arrangements in the oversight of capital markets, the SAMA should now consider stating more explicitly its oversight role and objectives in the field of payment and settlement systems**. Until now, there was no need to formally specify the SAMA's competencies in the field of payment and settlement systems because the SAMA was the sole body in Saudi Arabia operating and regulating different segments of the capital market infrastructure. Arrangements are changing, however, and, to avoid confusion (particularly among foreign market participants) regarding the allocation of roles and responsibilities in the domestic market, explicit clarity in the SAMA Charter would be beneficial.

C. Transparency

32. **Policy formulation and implementation is largely consistent with the IMF *Code of Good Practices on Transparency in Monetary and Financial Policy***. The SAMA Charter is clear on the monetary policy objectives of the SAMA, viz., to "safeguard the external and internal value" of the SRl. In practice, the SAMA maintains a fixed peg of the SRl to the dollar, and there have been no exchange rate adjustments since 1986. While major policy changes such as adjustments to the peg or to reserve requirements require the signature of the minister of finance, the day-to-day conduct of monetary policy is left under the purview of the SAMA. The principal instruments of monetary policy are the SAMA's repurchase and reverse repurchase facilities, although the SAMA may also from time-to-time engage in foreign currency swaps and mobilize accounts of public entities with the commercial banks. The SAMA is also designated as banker to the government, responsible for advising the government on debt management and reserves management, although a stipulation that it shall not extend loans or advances to the government, among other relevant provisions in its Charter, provides reasonable assurance of operational independence.[18]

33. **The SAMA serves as overarching custodian of the financial system**. The SAMA Charter is explicit in designating the SAMA as regulator of commercial banks and exchange dealers, although the minister of finance interfaces with the Council of Ministers regarding SAMA submissions on issues of bank licensing and intervention. In practice, having developed into a key repository of financial expertise, the SAMA has also served as regulator of mutual funds, the payment system, and insurance companies (formalized under the CIL). It has divested the regulation of the capital markets to the Capital Market Authority under the CML in July 2004. Each of the five specialized credit institutions and the three AGIs are governed by their own charters and are responsible directly to the council of ministers. The SAMA's regulatory framework is elaborated on in the BCL, supplemented by SAMA regulations, rules, and guidelines, issued as circulars. Detailed information on most of the above, including audited financial statements, is published in the SAMA's Annual Report and on its website *(www.sama.gov.sa)*, with the latter being developed at a rapid pace.

[18] Per a 1993 amendment to the SAMA Charter, the terms of office of the governor and vice governor are four years, extendable by Royal Decree, and that of other members of the board of directors is five years. Early dismissal requires the recommendation of the minister of finance, the approval of the council of ministers, and the issuance of a Royal Decree.

D. Market Integrity

34. **Saudi Arabia is compliant or largely compliant with most of the FATF *40 Recommendations*s for AML and *8 Special Recommendations for Combating the Financing of Terrorism* (CFT).**[19] The first customer-identification procedure was

35. implemented in 1975. A more extensive AML regime began to be put in place with the issuance of the 1995 AML manual and several other circulars from the SAMA and other government agencies. The AML Law, enacted in August 2003, provided a statutory basis for money laundering and terrorism financing offences, established a Financial Intelligence Unit (FIU), and enabled greater exchanges of financial information in suspected cases.

36. **The rules covering AML/CFT requirements for the banking, insurance, and securities sectors are comprehensive, while separate rules exist for money exchange business**. The SAMA plays a central role in overseeing all AML/CFT programs and supervises all banking, securities, and insurance activities in the country. Saudi Arabia is not fully compliant in three areas, however: (i) it lacks a clear definition of terrorism financing to ensure that it is an offence if the funds are intended for terrorist use; (ii) the requirement that all law enforcement requests for information from financial institutions, including those from the FIU, must be routed via the SAMA may delay unduly the process of providing effective legal assistance in AML/CFT inquiries or prosecutions; and (iii) there is a need to strengthen customer identification measures for nonbank financial institutions, including by adding the requirement to transmit originator information on wire transfers throughout the payment chain as called for under Special Recommendation VII.

VII. Access to Financial Services

A. Market Development Overview

37. **Despite the overall robustness of the banking system and the support infrastructure for its operations, banks' intermediation of domestic assets remains limited**. Banks appear reluctant to finance SMEs and the expansion of commercial banks into mortgage financing is constrained by uncertainties in collateral registration and enforcement. At least two banks currently offer housing finance loans on both "conventional" and Sharia-compliant terms. These schemes are essentially unsecured, as it is currently not possible to enforce and repossess residential housing collateral that is pledged for a mortgage. The banks rely for some security on liens on the borrower's salary. Currently, any cases involving repossession must be referred by the Banking Disputes Committee to the Sharia court, which reportedly does not allow repossession on grounds of compassion. A workable and effective framework for collateral enforcement could foster a major expansion of the market-based financial system.

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[19] This assessment is based on the FAFT mutual evaluation exercise that was conducted during September 21–25, 2003.

38. Comprehensive reforms to deepen financial markets and access to financial services, in support of accelerated growth and employment opportunities, are underway. The new CML and CIL are critical pieces of platform legislation that will substantially change the landscape of the provision of financial services. These, however, can be supported by broader institutional reforms that could also help accelerate the development of the financial sector.
Equity Markets

39. **The CML appears comprehensive and tailored to meet the contemporary needs of Saudi markets**. The SAMA and the new Capital Market Authority are developing coordination procedures to minimize conflicts, including through a memoranda of understanding. Among the challenges however is the need to manage risks that could arise from the markets' structure. The number of listed stocks, and the size of the free-float of shares is small. Margin trading is increasing and the introduction of a murabaha margin trading scheme, in addition to "conventional" margin trading schemes have enabled investors to trade Tadawul-listed stocks at leverage ratios of 150–200 percent. The limited participation of institutional ional investors in the market constrains intermediation of information, and a focus on promoting such services could be an important means of ensuring that investors act on the basis of real fundamentals than rumors.

B. Bond Markets

40. **The proposed introduction of a primary dealership system for government securities could be used as an opportunity to overhaul the functioning of the debt market**. As noted earlier, the SAMA's pricing of its repurchase facility may be inhibiting market development. Appropriately priced, access to this facility and other privileges could be linked to market-making obligations in the secondary market. Consideration could also be given to allowing primary dealers permission to take short positions. A further liberalization of repurchase intermediation to nonbank institutions would help increase and diversify demand for government securities and their trading. Tiered settlement arrangements for nonbanks under an independent direct account may be considered.

41. **The corporate bond market is still fledgling, and its development will require amendments to the Companies Law**. The Saudi ORIX Leasing Company offered the first corporate bond issue in March 2003, in an amount of SRl 45 million, and plans to follow up with an SRl 50 million private placement before end-2004. Under Article 117 of the Companies Law, the total amount of bonds that a company may issue may not exceed paid-up capital.[20] In all cases, and especially for financial institutions, including leasing companies, this constraint should be relieved as soon as possible. Cumbersome procedural requirements keep the issuing costs of short- and medium-term debt securities, such as

[20] The Minister of Commerce and Industry has the right to exempt any company from this article, and industrial and agricultural companies are currently exempt. The proposed Financial Leasing Law will also exempt leasing companies.

commercial paper or medium-term notes expensive. A broader choice of financial instruments would allow the capital market to better serve the economy, including those sectors that the banking industry has not been able to serve adequately. To facilitate such instruments, however, consideration may need to be given, *inter alia*, to the development of a credit ratings infrastructure.

C. Mutual Funds

42. **Complementing current regulations on investment funds and collective investment schemes, public availability of more explicit and objective standards for mutual fund regulation would remove ambiguities and support market development**.[21] Mutual fund supervision in Saudi Arabia relies substantially on the SAMA's overall supervisory control of local banks. Only Saudi banks are permitted to publicly offer, manage, administer, or act as custodians of mutual funds. Offshore funds, public and private alike, can be offered domestically only through Saudi banks. Mutual funds are collective contractual agreements between banks and unit holders, but do not form legal entities. Although Saudi mutual funds are generally subject to internationally established requirements for the industry, more explicit enunciation of and public information on regulatory standards and arrangements for dispute resolution would be beneficial. Consideration could be given to the benefits of organizing mutual funds into separate legal entities.

D. Leasing Operations

43. **A proposed Financial Leasing Law, now in draft form, is expected to address some important issues needed to accelerate the development of the leasing industry**. Though still negligible in size, the activities of the recently established leasing sector has been growing.[22] Leasing companies report that the central registry for all types of "moveable" collateral is effective. However, there is no central registry for fixed collateral or leased assets other than land and buildings which can be registered with the Notary Public. A commercial register that governs financial contracts or leases secured by property, such as a firm's equipment or receivables, may be needed. Further, development of a healthy and dynamic leasing industry would call for (i) improvements in the enabling legal environment, particularly to ensure easier access of the lessor to the leased asset in the event of default; (ii) more transparent rules on the accounting for the tax treatment of leases; and (iii) the creation of a registry for fixed or leased assets. Further clarity in these areas would help to reduce the administrative costs of leasing activity.

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[21] Regulations were introduced in June 1993 in a Ministerial Decree for Investment Funds and Collective Investment Schemes.

[22] Standard leasing contracts have been formulated by the SAMA in consultation with the Sharia court to ensure their compliance with the Sharia.

E. SME Loan Guarantees

44. **A loan guarantee scheme, to be managed by the Saudi Industrial Development Fund (SIDF), aims to promote commercial bank lending to the SME sector**.[23] For this purpose, SMEs are defined as companies having assets of SRl 50 million or less, a maximum of 250 employees, and a maximum turnover of SRl 10 million. Key features of the scheme would include (i) an initial contributions of SRl 200 million, funded half by the ten commercial banks (but in unequal shares) and half by the government; (ii) a guarantee fee and SIDF handling charges to the banks of about 175 basis points; (iii) guarantee ceilings of SRl 1.5 million and 75 percent of the underlying loan; (iv) durations of seven years on fixed assets and four years on working capital; and (v) possibly a cap on bank lending rates of 400 basis points over the Saudi Interbank Offer Rate.[24] The Fund contributions will be invested by the SIDF to generate returns for the scheme. Collateral, excluding owner-occupied residential housing, will be sought and held by the SIDF. In event of default, banks will notify the SIDF, which will execute the collateral in accordance with the Public Collections Act, which provides for an expedited collateral enforcement process without reference to the Sharia court. Banks are to receive 75 percent of their loan within three months of a declaration of default.

45. **The financial sustainability of the SIDF guarantee scheme and a possible use of an interest rate cap require careful consideration**. Expected revenues and losses would need to be assessed to help analyze the evolution over time of the financial equilibrium of the scheme. Throughout the world, loan guarantee schemes are notorious for eroding their capital over time. In addition, the SME projects may differ greatly in their risk profiles, even with the guarantee scheme. Thus, the presence of caps may lead banks to "cherry pick" their lending operations and may also promote distortions in the growth and evolution of the SME sector. It would be preferable, on a market basis, to avoid any caps and to allow competition among lenders to keep interest rate spreads low.

F. Housing Finance

46. **The current resources and programs of the REDF are unable to keep pace with the demography of housing demand, while collateral issues impede bank lending to the**

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[23] The Ministry of Finance issued a Ministerial Decision in June 2004 approving the program.

[24] A Board of Advisors will be established and will, *inter alia*, debate the pros and cons of an interest rate cap.

sector.[25] Smooth property registration, transfer of title procedures, and the ability to transfer mortgage liens are core to an efficient operation of a residential mortgage market**.** One current deterrence is the lack of a vehicle that recognizes creditor liens for owner-occupied property. To attract a greater number of investors, the legal and judicial systems need to recognize creditors' liens on owner-occupied residential property and permit and promote efficient, effective processes for protecting creditor rights in the event of default.[26] It is also important to ensure a level playing field for primary lenders to promote the emergence of a competitive mortgage market. Another important feature is the adaptation of prudential capital adequacy rules for banks' assets collateralized by residential property, in order to set the stage for risk-based pricing of longer-term loans.

47. **As a new mortgage market develops, new regulatory frameworks may need to be established for financial institutions**, as also for various types of real estate professionals, such as appraisers, mortgage brokers, and realtors. Equally, the insurance industry, which the government and the SAMA are currently restructuring, needs to adapt its products to the risks associated with the sector, for example, by extending the availability of property title insurance or, possibly, mortgage insurance for residential housing loans.[27]

VIII. Institutional Infrastructure

A. Credit Information and Risk Management

48. **The SAMA has gradually put in place various aspects of such systems that have helped to maintain the quality of loan portfolios**. Currently, credit information systems center on four negative lists. These include (i) a "B" list for larger companies having credit facilities over SRl 500,000; (ii) a "C" list for consumers (containing about 42,000 names) operated by the banks (with one bank as custodian) and under detailed terms of reference and criteria approved by the SAMA for listing and de-listing; (iii) an "E" list for the employees of

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[25] The REDF provides zero interest, 25-year housing loans in amounts of SRl 200,000–300,000 to eligible Saudi households, financing up to 70 percent of the estimated construction cost. The REDF's outstanding portfolio of housing loans totaled about SRl 69 billion at end-2002. In recent years, it has been extending new loans worth about SRl 2 billion annually, one-quarter the volume of new applications, resulting in an applicant waitlist that now stands at about ten years.

[26] The authorities have recently established a committee comprising representatives of the Ministry of Finance, the Ministry of Interior, and the SAMA to study issues related to mortgage financing in the Kingdom, with a view to possibly introducing a Mortgage Financing Law.

[27] The Implementing Regulations for the CIL were issued in April 2004, a new Insurance Supervision Department is being established within the SAMA, and corporate governance principles for the sector are pending.

banks; and (iv) a "M" list for merchants. Access to the B, C, E, and M lists is open to all financial institutions regulated by the SAMA, including banks, financial leasing companies, and insurance companies. A Credit Center for medium to large amounts complements the negative lists. In addition to the negative lists, the SAMA operates a "Credit Center" in which all transactions of individual and corporate borrowers in amounts of SRl 2 million and above are recorded and exposure assessed. It is an automated system that also checks for connected or related party lending. Reporting by banks to the Credit Center on a monthly basis is mandatory.

49. **The SAMA has encouraged consolidation and expansion of the service to foster further development of the financial system and enhancement of its capacity to support the growth of economic activity**. The new Saudi Credit Bureau, owned by banks, has been operational since March 2004, and has supplanted the "C" list with a positive list that will serve all sectors of the economy. Participation will be mandatory for financial institutions but will be open to all nonfinancial companies as well. The Saudi Credit Bureau will operate as a financial firm under the SAMA's purview.

B. Corporate Governance and Dispute Resolution

50. **With the enactment of the CML and the CIL, the structural and legal composition of the Saudi Arabian financial market is changing rapidly**. Both laws constitute significant tools for building commercial trust and are steps toward achieving compliance with IOSCO and IAIS principles. The adoption of these laws sends a significant signal of the move from a social to a commercial trust framework to govern financial activity. At the same time, the market is registering significant confidence in the ability of the Ministry of Finance, the SAMA, and the Capital Market Authority to manage the transition.

51. **The insurance and securities markets should emulate the SAMA's model and leverage the trust it has built by requiring companies to meet stringent corporate governance standards**. With both the insurance and capital markets undergoing significant reform, a formal review of corporate governance is premature. It is recommended, however, that the regulators review and apply, where appropriate, the OECD *Guidelines on Corporate Governance*, which represents current international best practice in the area.

52. **The need for specialized dispute resolution mechanisms and authority to resolve distressed businesses is of paramount importance to the investor community**. The commercial legal framework is a work in progress in Saudi Arabia. Areas that have not yet been addressed are contract law, competition law, and testing for the enforceability of the rules to prevent bankruptcy. At present, there are no codified regulations governing secured transactions, mortgages, pledges, or assignments. Provisions of the CIL and the CML calling for the creation of specialized Committees for Dispute Resolution in the respective markets are a necessary market innovation to settle disputes and enforce awards. Equally important, both laws grant the regulator the authority to supervise the compulsory or voluntary liquidation of the broker's business in the case of securities, or in the case of insurance to order the company to wind up business.

OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES—SUMMARY ASSESSMENTS[28]

Appendix I contains summary assessments of international standards and codes relevant for the Saudi Arabian financial system. The assessments have helped to identify the extent to which the supervisory and regulatory framework is adequate to address the potential risks in the system.

The following detailed assessments of financial sector standards were undertaken:

- The Basel Committee's Core Principles for Effective Banking Supervision, by Stefan Spamer (Deutsche Bundesbank) and Zarir Mohammad Rawi (Bank Negara Malaysia);
- The CPSS's Core Principles for Systemically Important Payment Systems, by Elias Kazarian (European Central Bank); and
- The IMF's Code of Good Practices on Transparency in Monetary and Financial Policies, by Francesco Drudi (European Central Bank).

The assessments were carried out during a mission to Saudi Arabia from January 9–25, 2004. All the assessments were based on the laws, regulations, policies, and practices in place at the time the assessments were made.

The assessments were based on several sources including:

- Self-assessments by the supervisory authorities;
- Reviews of relevant legislation, decrees, regulations, policy statements, and other documentation;
- Detailed interviews with the supervisory authorities; and
- Meetings with other authorities and independent bodies, including the Ministry of Finance, the Capital Market Authority, the SARIE, the Institute of Registered Accountants, auditing firms, and selected financial firms. The AML/CFT assessment included meetings with the Ministries of Justice, Interior, Islamic Affairs, Labor and Social Affairs, and Foreign Affairs, as well as law enforcement agencies.

I. BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

A. Main Findings

Objectives, autonomy, powers, and resources

53. **The basic legal framework is contained in the SAMA Charter and the BCL, supplemented by circulars and administrative guidelines issued pursuant to the BCL**. According to the Charter and BCL and supplementary regulations, the SAMA is the sole authority responsible for banking supervision. The BCL has not been amended since 1966. An amendment would be desirable, given the need, for example, to clarify the legal

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[28] The FATF's *40 Recommendations for Anti-Money Laundering* and *8 Special Recommendations for Combating the Financing of Terrorism*, has been assessed by an FATF Mutual Evaluation Team and a ROSC is under preparation.

conditions which permit the SAMA to exchange information with domestic and foreign supervisory counterparts. This objective could also be achieved through an amendment of the Ministerial Decision on Rules Enforcing Provisions of the BCL. There are no significant restrictions on the powers or actions of the SAMA owing to weaknesses in the primary legislation, however. Potential gaps in legislation and rules and regulations are filled in a relatively informal manner since the SAMA expects banks, for example, to implement guidelines and best practices.

54. **There is an appearance of a lack of operational independence in bank supervision, although the FSAP team did not discover any case where this was material**. Certain decisions of the SAMA, especially those regarding licensing and enforcement, are subject to approval by the Council of Ministers via the Minister of Finance. In addition, under Article 21 of the BCL the Minister of Finance may—in exceptional circumstances—exempt any bank from any provision of the law or subordinate regulations "for a limited period and subject to such other conditions as may be laid down in each case". The team has no evidence of this power being exercised. The SAMA has full budgetary independence and operates with adequate levels of supervisory staff.

55. **Legal protection for supervisors is currently not addressed Saudi Arabia**, **and there are no formal procedures for regular exchanges of information**. With respect to the latter, exchange of information, especially with foreign supervisors, is carried out on an informal basis—which has not prevented the SAMA from doing so.

Licensing and structure

56. **The BCL clearly defines the term "bank" and bank-permissible activities**. The use of the term and the proper taking of deposits is restricted to banks licensed under the BCL. Prior to engaging in banking business, each institution is required to obtain a license from the Minister of Finance, who is the sole authority for granting such licenses. The examination process is delegated to the SAMA. In the licensing process, applicants are required, on an informal basis, to provide the SAMA with all relevant information, including, for example, an operational plan, fitness and propriety of managers, suitability of shareholders, etc. Under the BCL, the SAMA has the power to grant authorization for the acquisition of ownership or interest in an existing bank. The SAMA requires notification but does not explicitly approve of the increase or change nor the transfer of such (significant) ownership or (controlling) interest in an existing bank. The law does not define a significant holding in a bank. The Economic Returns Management System (ERMS) has a definition of "major shareholding" which requires reporting of ownership in excess of 5 percent of voting shares.[29] The BCL defines the upper limit for investments in other companies at 10 percent of

[29] The ERMS is an online system used by the banking institutions to submit regulatory returns to the SAMA.

the paid-up capital of a domestic corporation with voting rights and 20 percent of the bank's paid-up capital and reserves. Supervisory approval is required to exceed these limits.

Prudential regulation and supervision

57. **Rules and regulations on capital adequacy generally conform to the 1988 Basel Capital Accord, except that they do not yet include a capital charge for market risk, mainly due to the small trading portfolios of banks**. The SAMA's current capital requirements are not based directly on the risk profiles of banks, other than in relation to credit risk. The SAMA takes comfort from the high CARs of Saudi banks, which are in all cases well in excess of the 8 percent minimum. Nevertheless, the capital charge on market risk is in the process of being addressed in a manner consistent with the 1996 Basel Amendments and is being considered for implementation in 2005. Capital adequacy is monitored on both a solo and a consolidated basis, mainly through the use of the ERMS. At present, "solo" and "consolidated" deliver the same result because banks do not have subsidiaries.

58. **In managing credit risk, the SAMA has outlined various rules and standards, which are largely consistent with the *Core Principles***. Even though the legal framework specifies requirements for credit exposures to connected parties, it is silent on the prohibition of lending to all connected parties on preferential terms and does not specify that approval for connected lending be carried out at the higher management/committee/board level. In terms of ensuring the adequacy of loan-loss provisions and reserves, the SAMA requires all banks to formulate their own provisioning policies, which need to be reviewed and approved by their boards. For consistency, the SAMA has introduced a guideline on minimum standards for loan classification and provisioning. Auditors are largely responsible for ensuring sufficient loan-loss provisions are made, through the annual audit process. Auditors are also responsible for ensuring that banks comply with all the rules and regulations issued by the SAMA.

59. **In the context of managing country risk and transfer risks, all loans to nonresidents must be approved by the SAMA**. Quarterly reporting through the ERMS of exposures to nonresidents facilitates the supervisory activities of the SAMA, particularly offsite supervision. The requirement also forces the bank to manage the exposures to nonresidents in a more active manner. Onsite inspection also facilitates the verification process.

60. **In addition to the rules issued by the SAMA, Saudi banks are encouraged by the SAMA to follow best practices and various principles issued and recommended by the Basel Committees**. Banks are also required to have an internal audit function and an independent credit review function, as well as two approved external auditors who are rotated every three years. The internal audit and independent credit review teams are required to report to the audit committee.

61. **The SAMA is an active member of the FATF and issued a new AML Law as well as supplementary AML/CFT and know-your-customer guidelines during 2003**. Onsite inspections have been carried out by external auditors to review banks' policies, practices, and procedures regarding the AML and know-your-customer initiatives. The inspection manual is comprehensive in this area, and the SAMA has the power to require correction of any deficiencies.

62. **Despite significant Sharia-compliant banking activities, the SAMA does not differentiate in its implementation of the *Core Principles***. In general, there is no difference in treatment of conventional and Islamic banking in the Saudi supervisory approach. There are only two occasional exceptions, neither of which are material:

- Banks are allowed to take certain risks in order to comply with Sharia principles, for example, potential commodity risk arising from the financing of trades.
- Banks are allowed to own real estate and develop real estate in order to sell according to Sharia principles.

Methods of ongoing supervision

63. **The supervisory function is effected through a combination of offsite monitoring and full- and limited-scope onsite monitoring**. The onsite monitoring can either be undertaken by the SAMA's own staff or by external auditors or jointly with external auditors. Bank information is verified and validated during the full-scope or limited-scope onsite visits or during the annual audits by the external auditors. The scope of annual audits includes annual financial statement certification and certification for compliance with various laws, regulations, guidelines, and SAMA circulars.

64. **The function of offsite monitoring is very active and greatly dependent on the ERMS, which has been in place since 1995**. The online reporting enables the offsite supervisors to analyze various data relating to capital adequacy, country risk, market risks, asset quality as well as other prudential requirements. The SAMA contacts the banks regularly during their offsite monitoring or when deviations from established trends are noted. If necessary, the offsite monitoring visits the banks, together with the onsite counterpart, to discuss any issues of concern. Meanwhile, the limited scope onsite monitoring is conducted when triggered by preexisting concerns on the part of the SAMA, or when requested by the offsite unit. The full scope onsite monitoring is not currently subject to a regular periodic cycle. In practice, the cycle is every three years after the date on which the "correction report" has been issued.

65. **The BCL provides general power to the SAMA to require a bank to provide any information it deems necessary**. The provision enables the SAMA to monitor the banks on both a solo and consolidated basis. Since Saudi banks do not currently have subsidiaries, "consolidated" and "true solo" are the same thing. The SAMA does not have explicit power

to allow it to perform supervisory functions on the bank holding company or sister companies, if necessary.

Information requirements

66. **Reporting requirements are based on Articles 15 and 17 of the BCL**. Article 14 requires the appointment of external auditors to report on the annual balance sheet and on the profit and loss account. The SAMA states that it requires banks to follow IAS and, in particular, IAS 39 for financial instruments. For independence purposes, the SAMA requires banks to appoint two external auditors, selected from the approved list issued by the Ministry of Commerce (in consultation with the SAMA). The external auditors are required to issue certificates of compliance with rules and regulations as well as certificates for the adequacy of the provisions made. Before the financial statements are published, the SAMA is responsible for reviewing and approving the annual reports. In cases where the SAMA wants additional work performed, it can commission the external auditors to conduct a special examination in accordance with the SAMA's scope and requirements. Although there is no specific provision that allows the SAMA to assess the quality of the external auditors' work, in practice, the SAMA could make a request to do so. The relationship of the SAMA with the external auditors follows the guidelines issued by the Basel Committee on the "Internal Audit in Banking Organizations and the relationship of supervisory authorities with internal and external auditors, 2001." The SAMA does not a have explicit power to remove the external auditors, but, alternatively, could remove the external auditor from the "bank approved list" or could influence the bank to terminate the services of the external auditors.

Crossborder banking

67. **The BCL provides the SAMA with the means to conduct the supervision of banks on a consolidated basis**. The current regulatory and supervisory framework does not have specific provisions relating to global consolidated supervision. However, banks organized under the BCL shall notify the SAMA for approval before they establish a subsidiary or branch outside Saudi Arabia. By being responsible for granting permission for Saudi Arabian banking institutions to operate branches outside the country, the SAMA has the authority to supervise the overseas branches of locally incorporated banking institutions, for example, through undertaking direct inspections. There are no legal provisions for the establishment of contact and sharing of information with other supervisors. However, the SAMA has initiated close informal working relationships with supervisors in territories where Saudi banks have overseas operations or where there are parent banks with operations in Saudi Arabia. Consideration should be given to formalizing the current informal information-sharing arrangements with foreign supervisors, especially so as to avoid restrictions with regard to confidentiality. Such arrangements would facilitate on-site visits, in line with the ongoing trend towards internationalization. However, current informal arrangements have not impaired the SAMA's ability to practice global consolidated supervision, including on-site inspections if necessary and sharing information with the host supervisor. Foreign banking institutions are subject to similar regulatory requirements

applicable to all other banks operating in Saudi Arabia. The current legal provisions give the SAMA powers to access any information on a subsidiary of a foreign banking institution.

68. **The SAMA has the power to share information needed by the home country supervisors for the purpose of carrying out consolidated supervision**. Nevertheless, there is no written or legal requirement for a formalized procedure in which the host country supervisor can share information on the local operations of foreign banks with home country supervisors, as confidentiality is protected. The SAMA can justify the exchange of information, which is not customer-specific with foreign supervisors because of Saudi Arabia's membership in international organizations (e.g., IMF, Basel Committee, etc). This exchange of information is approved by the Supreme Council of Saudi Arabia, as such an exchange is necessary for members of these institutions or committees. However, current informal arrangements have not impaired the SAMA's ability to share information with foreign supervisors, including granting access to the home supervisor for onsite inspections if necessary.

B. Authorities' Responses

69. **The Saudi Arabian authorities agreed with the main findings of the assessment, which they considered to be comprehensive**. They however felt that the lack of a market risk amendment was not a material deficiency given the small trading portfolios. The also felt that issues related to country and transfer risks were adequately monitored. Finally the authorities indicated that on information exchange the absence of explicit legal power arrangements have not hindered there capacity to exchange information historically.

70. **Notwithstanding, the authorities indicated their openness to consider recommendations seriously**. Already SAMA has indicated their intention to issue a circular on "Connected Party lending" and a draft circular on Market risks" has been issued to Saudi banks and its relevance being assessed.

Table 1. Saudi Arabia: Recommended Action in the Area of Banking Supervision

Reference Principle	Recommended Action[30]
1. Objectives, Autonomy, Powers, and Resources	
1.1 Objectives.	Amendment of the BCL to clarify law, rules and regulation and to formalize regulatory procedures.
1.2 Independence.	Amendment of the BCL to minimize the influence of the Minister of Finance and National Economy.

[30] The suggested actions that reference changing the primary Banking Control Law are moot. On the one hand such a change would provide specific legal certainty. On the other hand, changes in laws are invariably time consuming and not without risk of unintended dilutions. Moreover, it appears that supervisors have adequate powers and flexibility to act effectively

Reference Principle	Recommended Action[30]
1.3 Legal framework.	An amendment of the Ministerial Decision on Rules Enforcing Provisions of the BCL to clarify the scope of Article 16 BCL to regularize on non-credit matters under Article 3 (3).
1.5 Legal protection.	Amendment of the BCL or amendment of the Ministerial Decision on Rules Enforcing Provisions of the BCL to address legal protection for supervisors.
1.6 Information sharing.	Amendment of the BCL to clarify the legal gateways for an exchange of information.
2. Permissible Activities.	Amendment of the BCL to update the definition of the term "deposit."
3. Licensing Criteria.	Amendment of the BCL to bring into line the different capital requirements for domestic, GCC and foreign applicants of a license.
4. Ownership.	Amendment of Article 10 and 11 of the BCL to require supervisory approval and immediate notification of proposed changes that would result in a change in ownership or the exercise of voting rights over a particular threshold or change in controlling interest.
6. Capital Adequacy. Credit Policies. Connected lending.	Introduce capital requirement for market risk. On-site verification process should be more frequent. Regulations should explicitly give SAMA the discretion to interpret the definition connected parties and introduce regulations as needed.
11. Country Risk.	A specific and formal requirement for the banks to address country or transfer risk should be in place. The on-site verification process should be more frequent and the examination planning should be driven by risk-based methodology.
20. Consolidated Supervision.	The SAMA should consider itself to have specific powers to deal with mixed groups or non-bank affiliates. The BCL need to be updated to allow the SAMA to exchange information with foreign supervisors.
21. Accounting Standards.	There is a need to formally set requirements for external auditors to report breaches and all information of potential supervisory interest to the SAMA on a timely basis.
23. Globally Consolidated Supervision.	The BCL does not specifically allow SAMA to supervise Saudi commercial banks on a global consolidated basis. This issue should be clearly addressed in the BCL or in an amendment of the Ministerial decision on the Rules for enforcing Provisions of the BCL.
24. Host Country Supervision.	Consideration should be given to formalizing—e.g., through the development of a MoU or an exchange of letters of intent—the current informal information-sharing arrangements with foreign supervisors..

II. CPSS Core Principles for Payment Systems

A. General

This assessment of the payment systems in Saudi Arabia covers Saudi Arabia Riyal Interbank Express (SARIE) that provides real time gross settlement (RTGS) for Saudi Riyal transactions. A number of legislative and structural reforms are underway. Important in this regard are, the draft law for electronic transactions; a joint project with Tadawul aimed at developing new facilities in order to allow the provision of efficient and safe settlements for government bonds once they are migrated from SAMA to Tadawul; and projects in the context of the GCC payment systems co-operation for the preparation for the single currency 2010. Due to its relatively advanced system, SAMA is playing leading role in the region in the field of payment field.

B. The payment Infrastructure in Saudi Arabia

70. All interbank payment transfers in Saudi Arabia are processed through SARIE, which is operated and regulated by the SAMA. SARIE went into operation in 1997 and its functionalities and services have been enhanced continuously. It is a fully integrated RTGS system based on state of the art technology with an open and scalable architecture that allows the provision of new services and to deal with increased high transaction volumes.

71. SARIE is both a large-value and a high-volume payment system and handles both credit transfers and direct debits, and permits all banks in Saudi Arabia to make intermediate payments over accounts held at the SAMA. It is also the backbone for other payment and settlement systems operating in Saudi Arabia. It processes the banks' net positions in ATM and cards payment, cheques clearing, securities settlement systems for equities and government securities, into a single interbank settlement position that is settled through the accounts of banks in the books of the SAMA. As a high-volume system, it settles the banks' customers' payments and payrolls transactions.

72. As an RTGS scheme, SARIE settles payments by simultaneously debiting the sending bank's settlement account while crediting the account of the receiving bank. Any payment from the sending bank can not be revoked after SARIE has debited the sending bank's settlement account. Finality is achieved once the entries have been made on the settlement accounts of the sending bank and the receiving bank. SARIE will then send confirmation to both banks. The time length between receiving the instructions from the payment systems of the participant banks and the execution of the payments is within seconds.

73. In order to improve the efficiency of interbank payments settlement in SARIE, banks have access to intraday credits provided by the SAMA. These credits are fully collateralized by government debt instruments. The maximum intraday limit in the system is relatively high, SAR 14,9 billion, compared to the needs of the participants, which averages SAR 5,3 billion. SARIE participants have also access to repo transaction with the SAMA in the event

that they would need to exceed their limits to settle their payments. However, since the beginning of SARIE operation, no liquidity pressures have been experienced.

74. SARIE has 12 participants of which 11 commercial banks and the SAMA. According to the rules of SARIE, interbank payments must be settled through SARIE and only banks are accepted as participants. The total daily value of transactions processed through SARIE averaged SAR 21,4 billion. The bulk of these transactions is interbank payments with an average of SAR 19 billion, while the figure for customer payments (i.e., credit transfers) is around SAR 2,4 billion. The remainder is SAMA Debits, while the value of Direct Debits is currently negligible. However, the volume of customer payments accounts for 95 percent of the total transaction volume processed by SARIE. The share of the largest 5 banks in interbank payments processed by SAIRE is 72 percent in value and volume terms.

75. The trend for SARIE transactions in value and volume terms is expected to have a stable growth in the near future. However, the SAMA is anticipating that the interbank payments to slightly increase in both value and volume. Customer payments had a positive trend during the last three years and expected to grow between 15 percent and 20 percent. As the Direct Debit functionality is currently undergoing a revitalizing process, it is expected to increase substantially.

76. Payment cards (ATM and EFTPOS) are another non-cash payment instruments that have gained terrain in Saudi Arabia in the last years. The SAMA set up and operates the SPAN in 1990, and enhanced it in 1993 to support point of sale transaction. SPAN is a neutral national transaction system that works on the basis of full interoperability between the ATMs of all banks. This policy defined and enforced by SAMA has allowed a nation-wide ATM service coverage with a relatively modest employment of ATMs in the Kingdom. In 2003, there were over 3200 ATM terminals in SPAN, processing over 134 millions transactions annually for a total value of SAR 80 billion. Against the rapid and sustained growth for SPAN, SAMA has initiated a project to enhance SPAN infrastructure. In brief, this enhancement aimed at broaden the scope of ATM and Electronic Funds Transfer at Point of Sale (EFTPOS) services to allowing a centralised bill payment and cash-back at EFTPOS terminals; implementing and supporting smartcard-based credit and debit cards and introducing new electronic channels including e-commerce and m-commerce banking transactions.

77. The cheque payments are decreasing in importance as a non-cash payment instrument in Saudi Arabia, following the introduction of the electronic payments system SARIE in 1997. Cheques are cleared at local house maintained at each SAMA branch, where the clearance in the three largest branches is automated. The activities of the automated clearing houses (ACH) account for the bulk of cheques cleared in volume and value terms, the remaining cheques are cleared manually. The banks' net positions of cheques payments are settled in SARIE.

C. Main Findings and Recommendations

78. The mission has found that SARIE observes the applicable Core Principles. In addition, the four responsibilities of the central bank are observed. Nevertheless, due to the enormous importance of SARIE for the Saudi economy, further improvement of some specific aspects related to the governance structure of SARIE such as having a formalised Board of Governance of SARIE composed of Senior Executives from SAMA and banks would create an independent corporate structure where banks are involved in the management of SARIE. A dedicated Board for SARIE would also increase the awareness among policy makers about the crucial importance of SARIE for the Saudi financial market and increase clarity in respect with the decision making and ultimate responsibilities to define and implement payment system policy. This model would also be in line with the international practice.

79. SAMA may also consider stating explicitly in its Charter or other relevant legal documentation, its oversight role and objectives in the field of payment and settlement systems as a means to further increase clarity with regard to its regulatory competencies in the domestic market and to foreign market players and relevant public authorities. So far, there were no need to formally specify SAMA's competencies in the field of payment and settlement systems, as SAMA was the sole body in Saudi Arabia operating and regulating different segments of the capital market infrastructure such as payment systems, clearing houses, stock exchange and securities settlement systems.

80. Finally, SAMA could consider the possibility to set up a dedicate team "Payment and Settlement Systems Oversight Team" responsible to define policy, issue regulations and monitor all the payment and settlement systems operating in the Kingdom, including SARIE, SPAN, Clearing House, Tadawul's securities settlement systems, SAMA's settlement system. The Oversight Team would be composed of staff from different business areas within SAMA such as form the Banking Technology, Banking Supervision and Economists.

III. Transparency in Monetary and Financial Policies

A. General

81. **Monetary and financial policies are the responsibility of the SAMA,** according to the SAMA Charter, issued by Royal Decree No. 23 dated 23/5/1377 (15/12/1957) and integrated by subsequent decrees. In particular, the SAMA's responsibility is to stabilize the external and internal value of the SRl. With respect to financial policies, the Charter says that the SAMA has the objective to "regulate commercial banks and exchange dealers" (Article1). The Charter gives ample powers to SAMA as it adds in Article 3 that one of SAMA functions is "to regulate commercial banks and exchange dealers as it may be found appropriate

82. In exercising its responsibilities in monetary policy, SAMA maintains a fixed exchange rate of the Riyal against the U.S. dollar. To maintain the parity, SAMA adjusts the

interest rates applied to its facilities broadly following U.S. dollar interest rates, although spreads between U.S. dollar and Riyal rates may vary according to the market demand for the Riyal. SAMA influences banks' liquidity mainly through its Repo and Reverse Repo facilities. In addition it may conduct foreign exchange swap and mobilizes accounts of public entities with commercial banks. Banks are subject to reserve requirements. In its broader role in financial policies, Until now SAMA was the only financial agency. Its activity extends over the supervision of banks, mutual funds and the oversight of the payment system. Under the recently promulgated Law on supervision of co-operative insurance companies, new responsibilities have been given to SAMA to regulate insurance companies. The recently approved Capital Market Law has introduced a new agency dealing with the supervision of stock market (its relationships with SAMA are covered in the legislation).

83. **SAMA observes most of good transparency practices related to these responsibilities.** The ultimate objectives are clear and their relations with the conduct of monetary policy are explained in publications and speeches. Its objectives in financial policies are also outlined in various laws, which while referring to the regulation of commercial banks may be extended to the oversight of the payment system, that operates essentially through banks. The role of SAMA in the insurance sector has now been specified in the recently promulgated Law. In any case, SAMA provides ample explanations regarding its activity in its Annual Report and the institutional framework is understood by market participants and the public. The role of the Minister of Finance could be addressed in SAMA publications.

84. SAMA is currently making important efforts to broaden the frequency and scope of information released to the public by means of modern systems, including its website that is being constantly upgraded. It is important that such efforts continue and intensify (see Sections 2 and 3). The following sections review more in detail the finding for the various groups of practices. For an even more detailed assessment.

Clarity of roles, responsibilities, and objectives

85. The ultimate objectives and the relations to the actual conduct of monetary policy are clear and the institutional framework is explained in the texts of several laws and in SAMA publications. However, given the increasing degree of sophistication of the Saudi Arabian financial market, SAMA may now want to consider publishing a comprehensive publication of the institutional framework and characteristics of the Saudi Financial markets. In the event that SAMA decided to publish a Quarterly Bulletin, it may be even consider including in that publication articles regarding the Saudi financial system (in this context some mention of the role of the Minister of Finance can be added). While the various issues of the Annual Report already cover the main actions of SAMA, a comprehensive effort to explain to the public in a systematic way the roles of regulators and supervisors in Saudi Arabia would be beneficial.

86. **The relationships with the government are also clarified in legislations** and explained in SAMA publications. However, from an institutional viewpoint, SAMA may

consider to present in its Annual Report some considerations regarding the investments of the profits that are generated in the conduct of its activity.[31]

Open process for formulating and reporting of monetary policy decisions

87. **Most good transparency practices for formulating and reporting monetary policy are observed.** SAMA uses a variety of communication channels to explain its practices and to announce its decisions. **Some enhancements of the practices can be envisaged with respect to the timeliness in the explanation of the conduct of monetary policy**. At present, the main vehicle is the Annual Report, complemented by speeches of senior officials of SAMA. The high quality of the Annual Report has to be recognized. However the Annual Report, beside being published only once per year, is a publication which is relevant especially in terms of accountability, and therefore has to follow a particular procedure. Consequently, it is subject to delays. It may be therefore be considered by SAMA to publish a quarterly publication (e.g., a Quarterly Economic Bulletin), focused on monetary policy and on the main economic developments, which with short lags could inform market participants and the public at large. Speeches are important, but may not be sufficiently systematic.

88. In addition, **SAMA may consider to publish a technical booklet reviewing the instruments** and procedures for the implementation of monetary policy. This publication may cover features such as the characteristics of facilities, the criteria for having access to the facilities, the list of collateral. This will be more and more important as monetary policy instruments become more sophisticated in the Kingdom, alongside the developments in its financial markets. As it is the case of other central banks, such information should be posted in the website, complementing the information that SAMA has increasingly posted in its website (including BIS papers on monetary policy operations in Saudi Arabia).

Public availability of information on monetary policy

89. **SAMA publishes a wide amount of information in the Annual Report and its two statistical publications, the Monthly and Quarterly Bulletin. It complies with most requirements.** In addition, SAMA has launched a website that is being upgraded continuously, and which includes, at present the Monthly and Quarterly Statistical Bulletin and the statistical section of the Annual Report. The improvements that SAMA is making are so fast that it is likely that by the time this assessment is concluded other important steps will have be taken.

90. Given the institutional capacity to publish large amount of data with short lags, **SAMA may consider subscribing to the data dissemination standards of the IMF**.

[31] The IMF Annual Report on Exchange Arrangements and Exchange Restrictions on Saudi Arabia needs also to be corrected to fully reflect the current exchange rate framework.

SAMA balance sheets data are provided with short delays and include the relevant entries for end of period stocks. At present the main shortcomings relates to the availability of data covering the transactions made by SAMA (i.e., the amount of liquidity provided or withdrawn in given period of time with a breakdown of the different instruments used) on which only data in the Annual report are available. In addition, foreign reserves data are not as detailed as it is requested by the IMF DDS. As noted, SAMA started the practice to post selected speeches of senior officials in the website. This is a welcome development enhancing transparency.

91. The systematic publications of prudential circulars in the website is a very welcome development. The practice to make publicly available (in both Arabic and English) an increasing number of speeches of senior SAMA officials is also a welcome development.

Accountability and assurances of integrity by the central bank

92. SAMA publishes audited balance sheets, including a summary of profit and loss accounts. **It therefore broadly complies with the requirements on transparency concerning the publication of financial accounts**. It may consider, however, to publish more details of the profit and loss account, which at present is very aggregated. Regarding other practices, SAMA may consider providing, in the Annual Report, some information regarding its sound practices concerning internal audit and the conduct of its employees, without necessarily providing detailed accounts of such practices.

B. Authorities' Response and Recommended Next Steps

93. SAMA recognizes the importance of explaining monetary and economic developments of a key country such as Saudi Arabia to the general public. It is therefore considering whether to add a quarterly publication and further enhancing the availability of material related his instruments. The feasibility of such initiatives has to be assessed against the availability of resources. It has also to be stressed that many of preliminary recommendations formulated by the mission (for instance regarding the availability of speeches, regulations and data) have already been implemented by SAMA over the past few months. The mission strongly encourages SAMA to keep the current momentum.

94. SAMA will most likely post information on the rules of conduct for its employee in its website, to facilitate the public access to such regulations. In addition, SAMA is considering providing some information about its internal audit practices in its Annual report. As regards the publication of details of profit and loss account, the feasibility of such publication has to be further checked.

Table 2. Saudi Arabia: Recommended Actions to Improve Observance of MFP Transparency Code—Monetary Policy

Subject	Recommended Action and Timeframe
I. Clarity of roles, responsibilities and objectives of central banks for monetary policy.	Enhance disclosure of information on the criteria for the distribution/investment of surplus in the Annual Report. Publish a comprehensive study of the regulatory framework of the financial system of Saudi Arabia.
II. Open process for formulating and reporting monetary policy decisions.	Publish a Quarterly Economic Bulletin on economic, monetary and financial developments in Saudi Arabia. Publish a booklet on monetary policy operations in Saudi Arabia.
III. Public availability of information on monetary policy.	Enhance publication of data on central bank transactions. Subscribe to GDSS and SDSS of the IMF. Continue the practice of posting on the website publications, speeches and prudential regulations in the website.
IV. Accountability and assurance of integrity by the central bank.	Publish rules of conduct for SAMA employees. Cover internal audit practices in the Annual Report. Publish more details of the profit and loss account.